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SMALL ENTERPRISES AS AN ESSENTIAL PART OF THE INDONESIAN DEVELOPMENT STRATEGY

Robert C. Rice, Small Enterprises Advisor, Partnership for Economic Growth (PEG)[1] and Office of the State Minister for Cooperatives, Small and Medium Enterprises

March 30, 2000

In this paper first an international trade oriented strategy for Indonesian economic development is outlined which takes into account the sharp differences in population cultivable land ratios between especially Java and the large outer islands, building on the theories of John Mellor and Bungaran Saragih. Then the past role of small enterprises in Indonesian development and their expected future role are discussed, explicitly presenting some arguments for facilitating them, but also pointing out some of the difficulties in exporting their products. Finally a recommended strategy for SME development is presented building on the recommendations of a recent International Labour Office mission.

In the densely populated regions of Indonesia I emphasize capital and land saving development which utilizes underemployed and unemployed labor and technical change, because of the importance of increasing the output of the scarce land and capital resources by making fuller use of the millions of underemployed and unemployed persons along the lines advocated by John Mellor. In the less densely populated areas, agroindustries and agrobusinesses will have the leading role in development along the lines advocated by Saragih, along with the minerals sector in some areas. This paper also recommends making use of the "international trade production function" to increase total factor productivity and allocative efficiency in both densely and less densely populated areas by exporting low cost goods and services in order to finance the importation of high cost ones.

The second section of this paper is on the Role of Small Enterprises in Indonesian Development. Small enterprises have made very important contributions to Indonesia's development in the past and will continue to do so in the future given a favorable policy environment. Some arguments for facilitating

[1] PEG is a USAID-funded Project. The views expressed in this report are those of the author and not necessarily those of USAID, the U.S. Government or the Government of Indonesia.

small enterprise development are then presented, following by a discussion of some of the difficulties exporting the products of small enterprises, and possible solutions. The last section presents a recommended strategy for SME development which gives the highest priority to creating a conducive environment for SME development, followed by facilitating SME access to credit, finance, and other business services on predominantly market-based terms.

A Strategy for Indonesian Development

What is an attractive development strategy for Indonesia at the present time? By development we mean both an increase in per capita incomes and some increase in evenness of income distribution, the first two parts of the **Trilogi Pembangunan**. I am greatly influenced by John Mellor who advocated a development strategy for India in the 1960s. Indonesia today, like India, has very extensive disguised unemployment with also considerable open unemployment, and therefore it is very important to utilize productively this surplus labor.

The Mellor strategy has three elements:

1) **Agricultural development** utilizing new technologies [especially improved seed varieties which make yields more responsible to (saprodi) inputs], capital investment which is complementary to the use of labor (such as improved irrigation systems and increased use of fertilizers), and the development of institutions such as agricultural extension services, improved marketing, etc. Through these measures the marginal productivity of labor will increase, and it will become profitable for farmers to employ more people, who are in abundant supply. It discourages capital investment which substitutes for people, although in some cases this will still be attractive.

2) The **development of small, labor-intensive, widely scattered manufacturing industries**.

   The theory is that as farmers' incomes increase through agricultural production their demand for manufactures

will increase, and therefore the development of these manufacturing activities is important in meeting this increase in demand. Because the demand increase is widely scattered around the country the manufacturing activities can be also widely scattered.

So far the Mellor strategy is similar to the **People's Economy Strategy**.

However, with only these two elements very likely the demand for employees will not be big enough to employ all of the unemployed people. This is because as people's incomes increase, their demand for goods which use a lot of capital and little labor (capital intensive) also increases, but the country still does not have enough capital to employ all the unemployed people if they are used to produce capital intensive goods.

Also it will be very expensive to produce goods in which the country does not have a **comparative advantage**, and also some of the goods demanded **cannot be produced** at all because of insufficient technical know-how.

Therefore in the Mellor strategy, **international trade** is very important.

3) **International trade**

Some of the inputs required for agriculture, such as manufactured fertilizers and some pesticides, and inputs required by the manufactured industries are capital-intensive and therefore very high cost to produce in this poor country, or cannot be produced at all[1]. Therefore it is economical to import them. **Imports are very important in keeping the cost of production inside of the country low.** Therefore, **exports** are very important to earn the foreign exchange to finance the imports of some intermediate inputs, machinery and equipment, and consumer goods and services. The world market for export products is very important also for **employment and income generation**, because it makes possible the domestic production for export much more labor-intensive goods, and thus results in much more employment of otherwise unemployed labor from the capital invested and resultant production. Through international trade the ratio of the demand for domestically produced labor-intensive goods to capital-

intensive goods is much increased, which makes possible much increased employment and income from the capital invested.

In the case of Indonesia, adopting the Mellor strategy means that imports of phosphate fertilizers, cotton, wool, some synthetic fibers, animal hides, iron ore, some plastics granules, many basic chemicals, some components to be assembled, etc. as well as domestically supplied materials such as wood, minerals, palm oil, rubber, shrimp, fish, and other agricultural products, will be used to produce products for the domestic market and for export. It is efficient to import these raw materials and components because at the present time it would be high cost for Indonesia to produce them. By importing and utilizing them the country is able to realize much fuller its comparative advantage by producing especially the labor-intensive products. For example, with these imported materials, cloth and garments made out of cotton, wool, polyester and nylon, footwear, steel and steel products, plastics goods, toys, and electronics goods can be competitively produced for export utilizing the otherwise unemployed persons.

The small, labor-intensive, widely scattered manufacturing industries element in the Mellor model is somewhat weak because it is difficult to produce for export some labor-intensive manufactures in widely scattered plants because large factories are needed in order to guarantee a sufficiently high and uniform product quality for export markets and to fully realize economies of scale and scope. Also it is usually economic for those industries producing for export using imported materials to be located close to major harbors, rather than being widely scattered around the country. However, in spite of this, there still may a large potential for the development of small, labor-intensive, widely scattered manufacturing industries in Indonesia.

In many cases just because products are imported and exported now does not mean that they will be forever. As Indonesia's skills, know-how, and capital increase over time its comparative advantage will change, and we can expect that more and more of the imported goods will be produced domestically and eventually exported, in many cases by small enterprises. Other goods exported now will become importables. In Taiwan and Malaysia we have seen that industries which initially were dependent on imported inputs for their production, over time have more and more procured their inputs domestically, often from small and medium enterprises. The degree of this **backward integration** is also affected by the lowering of **transaction costs**, which is partially a function of

the demanders and suppliers of these intermediate inputs getting to know each other better and developing a relationship of trust, as well as improved contract enforceability. Also as the supply of human and physical capital increased and the price of unskilled labor increased, their comparative advantage changed from labor-intensive to physical and human capital-intensive goods, as is expected to happen eventually in Indonesia.

To summarize, the Mellor model is a model which promotes both the efficient allocation of resources and the full employment of the country's resources, especially its unemployed labor through both the production functions and technical change of the agricultural and manufacturing sectors, and the labor-intensive products produced, but also through increased demand for labor intensive goods relative to capital intensive goods through international trade. In addition underutilized natural resources can be more fully utilized through production for export, whether in the form of raw materials or finished products.

One might criticize this model by pointing out that the productivity of labor (that is, labor employed) is lower than if more capital-intensive products were produced. However, **the ratio of value-added (income) to the labor force is higher** because the increased employment results in an increase in value-added but not in the labor force. Also it is likely that the **total factor productivity** especially in social terms will be **higher** with the more labor-intensive industries[2].

The Mellor model is especially relevant for the densely populated islands of Java, Madura, Lombok, etc. because of the massive unemployment found. In the larger outer islands the ratio of population to natural resources (including cultivable land) and the rate of disguised unemployment are much lower, so labor-intensive industries are much less important and the mining, forestry, and agricultural sectors, including agroindustries are much more important. Therefore the Bungaran Saragih model which places a great emphasis on the development of agribusiness and agroindustries is much more relevant in these regions than in Java (Saragih, pp. 232-234 and 239-245). However, this is not to say that there is not considerable potential for the further development of agriculture and agroindustries in Java, but the fact is that the people of Java and the other densely populated islands can never become rich mainly through the development of agribusiness. The international trade element of the Mellor model is still important for the resource rich outer islands, because

world markets are needed to absorb the massive increases in output generated through agribusiness and agroindustrial development, for example in recent years the rapid increase in output and exports of palm oil. To summarize, all potential resources must be utilized for development: natural resources, domestic and foreign capital, unemployed and underemployed people, and employed persons' potential capabilities through increased human capital (skills, improved organization and management, domestic and foreign sourced technologies and other knowledge, etc.).

Java is similar to Taiwan and South Korea in the late 1950s and 1960s and Japan in the early 20th century because it has a very high population land/natural resources ratio and a low per capita income. Like these countries, probably for 10 or 20 years, like the 1985 to 1996 period, much of the driving force of its development will be from the rapid growth of labor-intensive industries producing for export and the domestic market[3]. However, we can expect, like these countries, that with time the supply of skilled labor, capital, and technological, organizational and managerial know-how will increase and Java will begin to produce products with a higher and higher value-added to labor hours worked ratio. It is important that while Java is in the process of developing making use of its abundant unskilled labor it simultaneously makes investments in human and physical capital especially in anticipation of the end of the labor surplus period when market forces will push up real wage rates. In general, the outer islands can utilize to a much greater degree their natural resources for development with agribusiness and agro-industry being relatively much more important than in Java.

The Role of Small Enterprises in Indonesian Development

There is no question that household, cottage and small (HCS) enterprises are very important in the Indonesian economy, especially in employment generation but also in income generation. The 1996 Economic Census revealed that there were 16.8 million **non-agricultural establishments** without legal entity employing 28.9 million persons (including the self-employed), or 1.7 employees per establishment.[4] This is about 34 percent of the 85.1 million persons working in 1996 and is in comparison with 31.5 million persons employed in agriculture in 1993, most of whom also work in small enterprises (the 1993 Agriculture Census)[5].

Undoubtedly many of the self-employed persons and unpaid family members are disguised unemployed persons[6]. Some people exploiting

a commonly owned resource even can have negative productivity--if they stopped working, in the longer run production would increase because there would be less overexploitation of the resource. An example is as follows: less people fishing along the north coast of Java would result in increased fish production because of less over-fishing.

In 1998 it was estimated that 89% of persons employed in Indonesia were in small (including household and cottage enterprises) enterprises accounting for 41% of Indonesian gross domestic product (See Table 1 below). Small enterprises in **agriculture** (including forestry and fishing) accounted for 51.9% of the Indonesians employed and 15.5% of GDP; **trade, hotels and restaurants** 20.7% and 11.8%; **manufacturing** 7.7% and 4.5%; **services** 4.1% and 2.9%; and **transportation and communications** 3.0% and 1.9% respectively (Departemen Koperasi, Pengusaha Kecil dan Menengah Republik Indonesia, pp. 48 and 52).

Using this Mennegkop (State Ministry of Cooperatives and SMEs) definition of enterprise size, Table 1 shows that in all of the sectors except for the Electricity, gas and water supply and Financial, rental and business services, small enterprises accounted for more than 50 percent of the employment. Small enterprises accounted for 90% or more of the employment in the Agriculture, livestock, forestry and fisheries; Trade, hotels and restaurants; and Transport and communications sectors in 1998. Medium-sized enterprises accounted for only 15.9% of manufacturing GDP while small and large enterprises accounted for 18.0% and 66.1% respectively in 1998. On the other hand, small enterprises in 1998 accounted for 58.3% of manufacturing employment, with medium and large enterprises accounting for 39.1 and 2.6% respectively. The GDP per employee of small and medium enterprises were quite close at Rp 8.49 and 11.13 million respectively, with large enterprises having Rp 701.24 million (Calculated from information in Departemen Koperasi, Pengusaha Kecil dan Menengah Republik Indonesia)[7]. A striking fact is that in 1998 only 220,971 persons were employed in large manufacturing enterprises (using the Mennegkop definition in end note 7), so even if they grew rapidly, employment generation would very likely be small. As discussed below, large enterprises were a lot more important using the Central Statistics Agency definition of large enterprises.

Table 1 also shows that small enterprises accounted for over 75% of GDP in the Agriculture, livestock, forestry and fisheries, and

Trade, hotels and restaurants sectors. Small enterprises were also very important contributors to GDP in the Construction, Transportation and communication, and Services sectors, and even more so if one takes small and medium enterprises together. Small and medium manufacturing enterprises taken together accounted in 1998 for 33.9 percent and 97.4 percent respectively of value-added and employment in manufacturing. Even though there is probably substantial sampling and measurement error in the figures in Table 1, the figures do indicate the approximate magnitudes of the contributions to GDP and employment of the nine sectors at the one digit level.

Large enterprises are more important in manufacturing when we use the Badan Pusat Statistik definition of household and cottage, small, medium and large enterprises, namely with 1-4, 5-19, 20-99, and 100+ employees, compared with the Mennegkop definition. The 1996 Economic Census and BPS Statistik Industri data show that in 1996, employment in household and cottage, small, medium and large manufacturing enterprises was 4.741, 1.873, 0.623, and 3.591 million respectively. Value-added per employee in small, medium and large manufacturing enterprises was Rp 2.985, 9.913, and 24.268 million rupiahs respectively. The value-added from large enterprises was more than ten times that of small and medium enterprises at Rp 87.15 trillion compared with Rp 5.59 and Rp 6.18 trillion for the small and medium enterprises.

Again looking at the manufacturing industry in 1996 using the BPS definition of size, 6.614 million persons were employed in household, cottage and small enterprises (HCS enterprises), which was 61 percent of the total manufacturing employment (Badan Pusat Statistik, 1998). However, they accounted for only 12 percent of the total value-added (income) from manufacturing. The value-added per worker of the HCS enterprises was only Rp 1.69 million compared with Rp 22.14 million for the medium and large (ML) enterprises. The HCS labor productivity is probably very low both because many workers especially in the household and cottage sector did not work the whole year in manufacturing and because they utilized less capital per worker, which is attractive because it means the very scarce capital resource is being used to employ more people. Even though the HCS labor productivity is much lower than the ML enterprises, their **total factor productivity (TFP)** is not necessarily lower. **More research is needed** on their relative total factor productivities, estimated using shadow prices of labor and capital.

Table 1. Sectoral Contributions to Gross Domestic Product and Employment by Size of Enterprise

Industrial	Small		Medium		Large		Total	
Origin	**V.A. %**	**Emp.%**	**V.A. %**	**Emp. %**	**V.A. %**	**Emp. %**	**V.A. (Rp billion)**	**Employ. (1000s)**
Agriculture, live-stock, forestry, & fisheries	79.1	98.0	16.7	1.9	4.1	0.1	184,221	34,270
Mining & quarrying	4.6	63.8	3.6	32.9	91.8	3.3	125,678	388
Manufacturing	18.0	58.3	15.9	39.1	66.1	2.6	234,503	8,550
Electricity, gas & water supply	0.6	34.5	8.2	59.1	91.2	6.5	11,149	121
Construction	41.2	55.8	23.7	43.2	35.1	0.9	55,591	712
Trade, hotels & restaurants	77.2	90.3	19.8	9.5	3.1	0.2	144,754	14,810
Transportation & communications	38.6	89.6	26.8	9.9	34.6	0.5	46,533	2,157
Financial, rental & business services	17.6	43.9	45.7	53.5	36.7	2.6	67,552	332
Services	37.2	78.8	5.9	20.4	56.9	0.8	72,863	3,338
Total	40.9	88.7	17.3	10.8	41.8	0.6	942,844	64,678

Notes: V.A. is the value-added contribution to GDP. The percentages (%) are the different size of enterprise categories as a percentage of the total for that industry. Emp. stands for employment.

Source: Calculated using data from Statistik Koperasi, Pengusaha Kecil dan Menengah, Jakarta: Departemen Koperasi, Pengusaha Kecil dan Menengah Republik Indonesia, 1999.

Because capital is the scarce resource and labor the abundant resource especially in Java, the use of less capital per unit of output (value-added) means that the output is greater than it otherwise would be if more capital and less labor were used per unit of output. The output can be greater because more of the otherwise unemployed labor is being used by the HCS enterprises.

So what can we conclude from this data about the role of small and medium enterprises in Indonesia's economic development? Because they very likely use less capital per unit of value-added created (lower incremental capital-output ratio or ICOR), and a lot more labor per unit of value-added, investment in these enterprises in general will result in more growth in value-added and employment than in large manufacturing enterprises, and therefore is generally desirable. However, we must not forget that in economic terms, employment is a cost, not a benefit, although in social terms increased employment spreads around the income generated more evenly. In economic terms the greatest attraction is their lower ICORs, although more research is needed estimating the ICORs of small, medium and large manufacturing enterprises producing the same products. The lower ICORs are attractive because it means more income is generated per unit of scarce capital invested, presumably with most of the increased income being generated from the higher labor-capital ratio employed in the small and medium enterprises. As probably in most industries larger firms have some advantages over small ones, smaller enterprises need to be facilitated to grow into larger ones resulting in even more income and employment generation.

One might ask however, is there really a potential for the small enterprise manufacturing sector to grow? I think yes, partly because of their strong performance shown from 1986 to 1996. Analysis using Statistik Industri and 1986 and 1996 Economic Census data show that the annual compound rate of growth of real value-added of small manufacturing enterprises from 1986 to 1996 was 11.9% compared with 15.9 percent for medium and large enterprises while their rates of growth of employment were 9.3 and 9.6 percent respectively per annum[8]. In other words, even though small manufacturing enterprises did not appear to grow quite as rapidly as medium-large ones during this period, they performed very well[9]. They should be able to perform even better in the future with more supportive economic policies, including little or no bias against them, unlike in the past.

One caveat on small enterprises and economic development is that

in some activities the unlimited entry of small enterprises into the activity results in the over-utilization of a common resource. Examples are over-fishing in some coastal water areas and many lakes and rivers, the cutting down of forest reserve areas resulting in erosion and flooding, and even the over-utilization of urban space. Many sidewalks, street corners, and other public areas are so crowed with sellers that serious congestion results--a social cost. In many cases there are too many traders in the sense that if they were somewhat fewer, the value of sales and services and the variety of goods offered would not significantly decrease, but there would be significantly less congestion problems. Whenever there are over-utilization of common resource problems, some means need to be found to limited the number of persons exploiting the common resource, so that the value of the resource in social terms can be sustained at its maximum value.

Arguments for Facilitating Small Enterprise Development

We can ask why do we want to promote small enterprises? One important **economic** reason is because in some subsectors the **total factor productivity in social terms** (using shadow prices) of small enterprises is greater than larger enterprises because they use sufficiently less capital in producing the output, even though they use more labor, but their TFP in money terms is less. If this is the case, the market will result in less production by small enterprises than is socially optimal. Much more research is needed about in which sectors and what localities is the TFP in social terms of small enterprises greater than that of larger enterprises but their TFP in money terms is less.

A second **economic argument** for government assistance is a type of external economies argument. Acs argues that small firms tend to have the innovative advantage in those industries that are highly innovative, where skilled labor is relative important, and large firms are present (Acs). Innovation by firms often produces external economies which benefit other firms. If indeed in particular industries small firms are more innovative and produce external economies, there is a theoretical argument for some assistance to them. However, we must always remember that even through in theory **market failure** may be a valid justification for government assistance, **government failure** may make that assistance so costly and inefficient that the government assistance is not desirable in social terms.

E. F. Schumacher considers a most important problem now is the question of "regionalism" in the sense that there needs to be a development effort outside the big cities covering all the rural areas wherever people happen to be (Schumacher, pp. 8-9). He seems to be implicitly assuming that if the market is left to take its course, development will be concentrated in the big cities. Small enterprises have the advantage that they can be scattered around the country. He also thinks that people will have greater freedom, human dignity, self-realization and fulfillment and be themselves only in small comprehensible groups, rather than large-scale factories. "Therefore we must learn to think in terms of an articulated structure that can cope with a multiplicity of small-scale units"(pp. 9-10). Schumacher favors production by the masses relative to mass production, which is based on sophisticated, highly capital-intensive, high energy-input dependent, and human labor-saving technology. "The system of *production by the masses* mobilizes the priceless resources which are possessed by all human beings, their clever brains and skillful hands, *and supports them with first-class tools.* The technology of *mass production* is inherently violent, ecologically damaging, self-defeating in terms of non-renewable resources, and stultifying for the human person. The technology of *production by the masses*, making use of the best of modern knowledge and experience, is conducive to decentralization, compatible with the human person instead of making him the servant of machines. I have named it *intermediate technology* to signify that it is vastly superior to the cheaper, and freer than the super-technology of the rich (pp. 11-12). I think that Schumacher's argument is overstated, but there probably is some truth in it.

Harper gives various arguments why we should be trying to help small enterprises. These are among others 1) because "people are happier working in small units where they know everybody are involved in the whole manufacturing process", 2) small enterprises can be scattered across the country as the people are and do not require the creation of jobs in the cities, which results in the migration to the city of more than one person for every job, resulting in urban unemployment, 3) small enterprises tend to use more local rather than imported materials, including materials which would otherwise be thrown away, 4) some small businesses grow into larger businesses, 5) small businesses are able to produce a wide variety of products in demand and they are flexible enough to change and adapt when our needs change. "Really good things are invented by individuals not by committees. In the same way, small enterprises come up with good ideas far more quickly

and far more often than large ones do. If they fail the individual cost is small, but big firms cannot risk failure; this means that they often fail to introduce new ideas at all, and 6) Small enterprises can strengthen the family and help to mobilize peoples' savings for investment in their own businesses (Harper, 16-18). The extent to which his arguments are valid for Indonesia also **needs to be further researched**.

Even if the statements by Harper and Schumacher above were true, it is not clear why the market mechanism results in a smaller proportion of production by small enterprises than is socially desirable, and therefore intervention in the market by the government may be desirable. If people are happier working for small enterprises than larger ones, then presumably they are also willing to work for lower wages, and this then increases the profitability of small relative to larger enterprises. Harper does not make clear what he means by "help small enterprises". If he means subsidizing them in some way, then there needs to be a justification in terms of external economies produced or the social cost of a factor of production is less than its money cost (such as unskilled labor in many densely populated countries), and therefore subsidization of the use of the factor of production may be justified. However, if he means assisting them by ensuring that they are not discriminated against in favor of larger enterprises by the government, by ensuring that they are given a "level playing field", or that they are given their "fair share" of government services and social overhead capital provision, then few would argue against this kind of assistance.

There also of course may be **social and political arguments** for assisting small enterprises. For example in Malaysia the Government made the political decision to assist indigenous firms. To the extent that most small enterprises are owned by indigenous people, the Government may decide to assist them on social and political grounds.

Some Difficulties Exporting Products of Small Enterprises

We now briefly discuss some difficulties in exporting the products of small enterprises.

1) The smaller the enterprise the more difficult it is for it to export itself, as distinguished from producing exportables (goods that are both exported and consumed domestically). Therefore it is difficult for small

enterprises to export themselves, except perhaps to nearby markets like Singapore and Australia, and indirectly exporting by selling to tourists.

2) Homogeneous commodities such as coffee, rubber, pepper and copra are commonly produced by many small producers. The degree of product uniformity of agricultural products is to some degree controlled by nature, such as by the seed varieties used. This is also somewhat true of minerals, especially through the processing methods used. It is much more difficult to obtain product uniformity in the production of differentiated manufactured products by small producers. In many markets and for many products in order to export them it is necessary to produce products in large volumes with product uniformity, which makes it difficult to export differentiated goods made by small firms.

3) Because of the above factors, in order to export differentiated manufactures produced by small firms usually large exporter firms are needed to purchase their manufactures and work together with them to ensure greater product uniformity and quality control.

In order to facilitate economic development, it is **very important** that Indonesia and other densely populated developing countries (DGCs) export **products in which they have a comparative advantage** both in order to increase incomes as well as more fully utilize the unemployed labor. There is relatively little difficulty in achieving this for homogenous products produced by large and small firms and differentiated products produced by large firms. However, it is difficult to accomplish for differentiated products made by small enterprises (SEs).

There are five types of large enterprises which could help organize the production and export of differentiated goods made by SEs: 1) private exporter/trading houses not owned by SEs, 2) incorporated exporter/trading houses owned by the SEs or other cooperatives of SEs, 3) cooperative exporter/trading houses owned by the SEs, 4) state enterprises, and 5) combinations of these types of enterprises--for example a company with some of the shares owned by SEs.

Probably most commonly the exports of the SEs are organized and

executed by the first type of enterprise. However, in some cases this may be unsatisfactory because a large enterprise uses its strong competitive position relative to the SEs to press down the prices paid for their differentiated products. The relationship between the exporting firm and the SEs is commonly by necessity a complex and long-term one. The exporting firm may work closely with the SEs in order to ensure that their products fulfill the demands of the export markets in terms of their design, quality and quality control. Often also the exporting firm supplies credit and raw materials to the SEs. Small exporters including foreigners can and have been in Indonesia important as exporters of SE products such as furniture and garments.

If the SEs find that it is unsatisfactory to export their products through private exporter/trading houses not owned by them, then they may consider the other alternatives. A possible difficulty with types two and three is that usually for an export firm to be economically viable it needs a large volume of exports. Therefore, in order to be viable it may need to export the products of many SEs, which may make the management and ownership of type two and three enterprises not viable because of difficulties in organizing the large number of SEs.

Export enterprise types four and five could be attractive. There still are state trading enterprises that perhaps could be mobilized for exporting these products. Another possible option might be for a state enterprise to form a subsidiary which is partially owned by the SEs so that they can influence its management through their representatives on the Board of Directors.

The BAPPENAS-GTZ SME Promotion Project has prepared a proposal for Blue Book Presentation for a project with the title "Implement Joint Business Ventures with Large Corporations", with the objective of integrating cooperatives into regional/global economy. Under this draft action plan project it is proposed that Koperasi Bisnis Indonesia, as the holding company set up by DEKOPIN to develop international trade undertakings, be assisted to identify and prepare commercially viable joint venture proposals to take to large private and State-owned enterprises.

A Recommended Strategy for SME Development

From 20 April to 18 May, 1999 an International Labor Office

Employment Strategy Mission visited Jakarta. Max Iacono, a member of this mission, prepared "Input Report on **Small and Medium Enterprise Development and Large Enterprise Restructuring**", dated May 28, 1999. He recommends a **Strategy for SME Development** comprised of 'three main "strategic orientations". The **first** of these aims at creating a conducive environment for SME development. The **second** aims at providing financial and non-financial services in keeping with international best practice. The **third** aims at more efficient use of national and donor resources and more effectiveness in directed programs by means of improved institutional approaches in design and delivery. (Iacono, par. 20, page 7).' We now look at them one by one.

1) The **first "strategic orientation"** of creating a conducive environment for SME development **emphasizes** both macro and sector-specific policy reforms in the trade, fiscal, monetary, competition and regulatory policy frameworks over specific targeted programs for developing the SME sector. In other words programs that favor SMEs should not be used to try to compensate for existing or remaining macro or sector-specific policy distortions, but instead **any laws, regulations or policies causing the distortions first should be reformed** (par 21, p. 7). There needs to be developed a conducive legal, regulatory, competition, business, and trading environment for SMES **within each of the main economic sectors** and **sub-sectors** that are **relevant within specific regions and localities.** Iacono is correct in pointing out the **need to be sub-sector and locality specific.**

A question here is to what degree and how is the environment for SME development **not conducive** because of damaging laws, regulations, restrictions on competition, taxes, "red tape", levies, etc. The first step (and a low cost step) towards improving the environment for SMEs is to take firm actions to lessen and hopefully eliminate these obstacles.

Some questions in connection with the above could be asked, for example:

1. Do regulations such as tax concessions and the provision of public facilities such as infrastructure favor large enterprises?

2. Are monopolies given to certain enterprises to supply,

purchase, or generally trade certain goods or services?

3. Are credit subsidies given to larger enterprises more favorable than those given to small enterprises? In a conference of small enterprises held on October 7 and 8, 1998, there was discussion about local and central government regulations, policies and business climate which discriminate in favor of strong economic actors in the form of opportunities, chances and facilities and tend to put to the side or give a low priority to the existence of small enterprises (Priyono, 1999, p. 164).

4. Are there bans on some economic activities dominated by small enterprises which should be changed in order to create a "fair" competitive environment for small enterprises? Some examples possibly are bans on *becas* in some cities, restrictions on certain types of commercial vehicles in cities--such as motorized *becas* apparently in many cities, restrictions on selling on sidewalks and streets during certain times of day, etc.[10] We are **not saying that bans on certain activities are necessarily undesirable**, but they need to be carefully reviewed keeping in mind the desire to provide a **level playing field** for small enterprises. One could ask the question, do small sellers, as citizens, have the right to use part of the street space for selling during off-peak traffic hours? Or, how about selling goods at traffic lights in the street (*pedagang asongan*)? What are the benefits and the costs of these activities from a social viewpoint?

Many decision makers have higher degrees from rich countries and of course observed that traditional markets, *becas, ojeks*, *bajaj*, sellers on sidewalks and at traffic lights, small restaurants on streets and sidewalks at night, scavengers, persons sorting and recycling waste material, persons manufacturing at home, persons with small stores in the front of their houses, etc. are rarely found in rich countries. Therefore they might conclude that if these activities are found in their countries it is a sign that their country is not "modern", and they might take actions to restrict or eliminate the activities in order to become more modern. Or possibly also these activities interfere with the lifestyles of the rich and powerful, such as having their

cars slowed down by *beca* and horse cart traffic, and therefore they pressure decision makers to restrict these activities.

Perhaps an example of a policy actually inhibiting the activities of small enterprises but giving the impression of still allowing them to run viable businesses is the case of the Jakarta Pusat Government preparing 376 locations for mobile traders and newspaper sellers banned from selling at intersections with red lights ("Pemda Jakpus Sediakan Tempat Bagi 512 Pedagang Asongan"). What seems to be not recognized by this decision is that the major reason these sellers are able to sell their newspapers and other goods is because they have come to where the customers are. In fact, one of the main factors that makes small retailers competitive is that they can bring their goods and services to the customers, rather than requiring the customers to come to them as is the case with stores at fixed locations. Certainly the above actions by the Central Jakarta Government will result in a sharp decrease in their sales and the non-viability of many of their businesses.

This is not to say that the Central Jakarta Government has necessarily made a bad decision through this banning, because indeed there is an external diseconomy created by the traders selling at traffic lights--they do somewhat interfere with traffic flows. This social cost must be compared with the benefits of allowing them to sell there in making a policy decision.

However, in poor countries with enormous unemployment problems like Indonesia many of the above activities productively employ this otherwise unemployed labor, and therefore must not be unfairly obstructed. Especially in times of crisis like now in Indonesia, these activities are especially needed.

Another matter of great importance is the understanding of the relationship between small sellers and small producers of differentiated products. Many products produced by small producers are produced in small quantities and are of variable qualities. Therefore, they are not very suitable for sale in stores which have fixed prices, because with the variable quality indeed the price of one piece of a good should be different from another piece of the same good--for

example the quality of one pair of sandals of one type may be different from another pair of the same type. Therefore for many goods a hypothesis is that the marketing of many products made by small producers is very dependent on small retailers selling them. Therefore restrictions on small retailers trading will have an adverse effect on the demand for many of the products produced by the small producers. For example, restrictions on sidewalk traders very likely will result in a greater percentage decrease in demand for products made by small producers than by larger producers.

Another question of importance is what has been the effect of banning *becas* on the competitiveness of sellers in traditional markets compared with stores. Many sellers in markets use *becas* to bring their goods to market, presumably because they find it is the most efficient way to do it. Thus, when *becas* are banned, their costs of trading must increase, consequently decreasing their competitiveness in the market. **More research needs to be done** about this and the relationship between small retailers and small producers of especially differentiated products.

What are the **unnecessary fixed costs** or fixed costs which are excessively high that are born by small enterprises? If a fixed cost is the same for a small and large enterprise, clearly it more adversely affects the ability of the small enterprise to compete than the large firm, which can spread it over a large volume of sales.

Of particular concern is the **cost and number of licenses required by small businesses**. A conference of small enterprises organized by the Asia Foundation obtained input from small agricultural, food, textile, wood and handicraft, leather, metal, trade and service sector enterprises and reported on problems in obtaining licenses and with the services of bureaucrats (Priyono, 1999). They commonly reported that it was difficult to find out actually what permits were required, many different kinds of licenses were required and the procedure for obtaining them was arduous (berbelit-belit), officials had difficulty interpreting the licensing policy, and the mentality of bureaucrats was poor resulting in corruption and illegal levies (Priyono, 1999, pp. 13, 22-23, 40-41, 55, 78, 86, 102-3, 115, 163-8).

For many economic activities there is the question **whether it**

is desirable to require the enterprises to obtain a license at all, as opposed to just requiring the enterprise to register. There is a sharp difference between obtaining a license, which requires approval from a government office, and registering, which requires no approval. Undoubtedly there are many economic activities where a license is now required with there being little justification for it, as opposed to only requiring the enterprise to register.

There is also the problem of levies that may adversely affect small enterprises. For example, if a 5 ton truck has to pay the same levies as a 20 ton truck passing traveling between two points, the small truck's cost per weight of cargo is greater. Similarly if a large store has to pay the same daily fee in a market as a small store, the fee per sales volume is greater for the small store.

For the exploitation of common resources, such as fisheries, pasture, and forestry resources, but also to some extent urban space, water and air, there are **very serious problems of overexploitation of these common resources**, or the **"tragedy of the commons".** These are caused by insufficient or inappropriate regulations, lack of the use of other mechanisms to limit the access to commonly owned resources, or ineffective implementation of regulations, which results in the overexploitation of the resource and less output and income than its maximum sustainable output and income. Commonly it is the small enterprises which suffer from this--such as the artisan fishermen along the north coast of Java, farmers whose fields are eroded or flooded because of excessive cutting of trees in watershed areas upstream, small pastoralists, and even urban sidewalk and mobile traders who suffer from congestion caused by overcrowding. In these cases improved regulations which are more effectively enforced are needed.

2) The **second "strategic orientation" proposed by Iacono** costs money. It is "the design and implementation of institutional packages based on international best practice to focus on two fundamental areas of support to SMEs: **i)** Developing better and simpler access to credit and financial services for as many viable firms as possible on **market based terms** and for optimal and productive use", and "**ii)** Developing access to the **most appropriate range** of general, **sector, and locality-**

specific business services also to be provided in keeping with international best practice."

This implies "a deliberate effort to shift business services from being a) "supply pushed" to being "demand driven" b) from being provided by government to provision by the private sector and c) towards the design of programs by a more transparent and consultative process that will include relevant Ministries, NGOs, private service providers, industry representatives and SMEs themselves." The inclusion of all relevant stakeholders in designing the programs will ensure that more appropriate programs can be developed that are less prone to capture by special interest groups.

3) The **third and final recommended "strategic orientation"** is to place a greater emphasis on the coordination of policies and programs for more efficient utilization of **national** and **donor** resources. "This can be achieved by reaching agreement on an overall SME development strategy and its supporting policies and by a more effective design and delivery of programs through renewed institutional structures, methods and procedures" (par. 26, p. 8). The Government of Indonesia formed a Coordinating Team for Managing Programs to Increase Industrial Competitiveness and to Develop Small Medium Enterprises and Cooperatives (Tim Koordinasi Pengelolaan Program Peningkatan Daya Saing Industri dan Pengembangan Usaha Kecil, Menengah dan Koperasi) on 18 February 2000. Under this team a Working Group for Developing Small Medium Enterprises and Cooperatives (Kelompok Kerja Pengembangan Usaha Kecil, Menengah dan Koperasi) was formed on 7 March 2000. This Team and Working Group should be able to take the lead in coordinating the SME policies and programs of Indonesian entities and foreign donors in accordance with an overall SME development strategy.

This strategy with three "strategic orientations" proposed by Iacono is very attractive. However, much more work needs to be done on spelling out in detail the contents of the strategic orientations and formulating and implementing the most attractive action plans.

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END NOTES

1. Urea and some other natural resource intensive and capital-intensive products are an exception to this in Indonesia, because of the very low opportunity cost of the natural resource used, such as natural gas.

2. Any variable measured in social terms means that we use the social costs (which may be different from costs in money terms) of the inputs and factors of production used, the social value (benefit) of the outputs produced, which means we adjust the costs and benefits for any external economies or diseconomies produced. In calculating social cost we use shadow prices, which are approximately the same as opportunity costs.

3. We need to distinguish between sectors that drive the economy forward and ones that follow. Sectors producing for export markets are generally supply driven, and create the increases in incomes which cause increases in demand for other goods and services, such as retail trade and many types of services such as retail, recreational, higher quality housing and medical services, etc. The production of these latter sectors mainly increase in response to this increased demand. Thus for every additional person employed in manufacturing, additional jobs are created in other sectors through this demand effect. Efforts to directly increase jobs in these service sectors without increases in incomes will usually quickly run into demand barriers. Efforts to increase output in agriculture in Java through increased employment and capital investment commonly result in little increase in output because production methods are already very labor-intensive and the land area cultivated can be little increased. However, there is still some potential for productive employment generation in agriculture in Java in the way it was attained in the past, through labor-using technical change, increased intensification in the use of land through improved irrigation, and cultivating new crops.

4. Establishments without legal status are those which are not PT Persero/Perum, PT, CV, Firma and special identifications such as Koperasi and Yayasan. However, included in this data for "establishments without legal status" are the data for all the manufacturing sector establishments with 1 to 19 employees (including the self-employed and unpaid family members) whether they were with or without legal status.

5. Here household, cottage and small enterprise is defined as having 1 to 9 employees, including non-paid family workers. This is the definition used by the Central Bureau of Statistics.

6. A person is disguised unemployed if the output stays the same even though he is not working--usually because the remaining persons work longer hours or because the remaining persons can handle the same volume of business working the same number of hours. The former case is found in family farm agriculture and laborers waiting around for work in warehouse areas. The latter case is commonly found among *beca* drivers, sidewalk traders, repair persons in public areas, etc.

7. Here household, cottage and small enterprise is defined as an enterprise having sales less than one billion rupiahs per year. A medium enterprise is defined as having sales from one billion to just less than 50 billion rupiahs per year, while a large enterprise has sales of 50 billion or more rupiahs per year. Let us call this the Mennegkop definition in contrast to the BPS definition of endnote 4. This definition of small enterprises in terms of sales is the same as that in The Law of The Republic of Indonesia Number 9 of The Year 1995 Concerning Small Business, although this law has some other criteria which have to be fulfilled to be considered a small enterprise. This definition of medium enterprise is very different from that in Instruksi Presiden Republic Indonesia Nomor 10 Tahun 1999 tentang Pemberdayaan Usaha Menengah.

Much of the difference in value-added per employee in the aggregate between the large and smaller manufacturing enterprises is because to a large degree different industries are being compared. This is because in some industries like petroleum refining and cement, practically all are large, while in other industries like food processing there are many smaller enterprises.

8. The value-added data in 1996 was converted into 1986 prices using the GDP deflator for manufacturing industries, and then used to calculate the real annual compound rate of growth.

9. The rate of growth of medium-large enterprises is actually overestimated because some of this growth shown came from small enterprises growing up to become medium-large ones.

10. The City of Medan is considering phasing out motorized becas. Without knowing their reasons for this, we can surmise that perhaps it is because they are noisy and create quite a lot of air pollution. Rather than phasing them out it might be better to require them over a fixed time period to become quieter and create less pollution, such as by using 4-stroke instead of 2-stroke engines and better mufflers.